89-818 (1)

No. _____

IN THE

Supreme Court of the United States

OCTOBER TERM, 1989

MORTON H. JAFFE,
Petitioner,

vs.

MICHIGAN DEPARTMENT OF TREASURY,
Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE COURT OF APPEALS OF THE STATE OF MICHIGAN

MAURICE S. REISMAN (P28847)
Attorney for Petitioner

32255 Northwestern Highway
Farmington Hills, Michigan 48018
(313) 855-4020

FEDERAL
QUESTIONS PRESENTED

I

Whether, in the determination of a unitary business, the State of Michigan Court of Appeals has authority to add additional criteria contrary to the decisions of the U.S. Supreme Court, thereby negating those decisions.

II

Whether, having found that Petitioner's in-state and out-state business segments met the U.S. Supreme Court's unitary test of centralized management, the Michigan Court of Appeals can then rule that this business was not unitary — thereby depriving Petitioner of equal protection and due process guaranteed by the U.S. Constitution.

III

Whether the State of Michigan Court of Appeals has decided a substantial federal question before it so as to conflict with applicable decisions of this Court, particularly *Container Corp. v. Franchise Tax Board,* 463, U.S. 159 (1983).

IV

Whether the State of Michigan's arbitrary establishment of its own unitary business criteria—which conflicts with those afforded petitioners in other states which follow this Court's decisions as in *Container*—deprives Petitioner of his rights to due process, equal protection and treatment guaranteed under the U.S. Constitution.

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PETITION FOR A WRIT OF CERTIORARI TO THE COURT OF APPEALS OF THE STATE OF MICHIGAN

Morton H Jaffe petitions for a Writ of Certiorari to review the Judgment and Opinion of the Court of Appeals of the State of Michigan, entered in the above-entitled proceeding on July 26, 1988.

OPINIONS BELOW

The opinion of the Michigan Court of Appeals is reported at 172 Mich. App. 116, 431 N.W. 2nd 416 (1988) and is reproduced in Appendix A, pp. 1A - 4A *infra.* The Opinion and Judgment of the Michigan Tax Tribunal is unreported and is reproduced as Appendix B, pp. 5A - 14A *infra.*

STATEMENT OF JURISDICTION

The Court of Appeals of the State of Michigan issued its Opinion and Judgement on July 26, 1988. The opinion is reprinted in Appendix A hereto, pp. 1A - 4A, *infra.* On September 13, 1988, Petitioner filed a timely Application for Leave to Appeal with the Supreme Court for the State of Michigan. The Supreme Court entered an Order denying the Application on June 7, 1989.

The Order is reprinted in Appendix C hereto, p. 15A, *infra.* The Supreme Court entered an Order denying Petitioner's timely Motion for Reconsideration on August 29, 1989. The Order is reprinted in Appendix D hereto, p. 16A, *infra.*

The Jurisdiction of this Court to review the Opinion and Judgment of the Court of Appeals of the State of Michigan is invoked under 28 U.S.C. SS 1257(a).

STATUTES INVOLVED

Relevant provisions of the Michigan Income Tax Act, MCLA 206.1 *et seq;* MSA 7.556(101) *et. seq.* are reprinted at Appendix E, pp. 17A, infra.

STATEMENT OF CASE

The issue presented by this case is the proper test to be applied by a court in determining whether a business conducted by an individual proprietor is unitary for tax purposes.

The Petitioner is engaged in the advertising and beef production business as a sole proprietorship. He does not employ anyone to engage in the livestock feeding activities, but instead, as a feedlot customer, utilizes the services of various Texas feedlots who act as independent contractors.

From his only office in Southfield, Michigan, Petitioner himself conducts all transactions relative to the purchase, feeding, financing and the sale of his cattle.

Petitioner did not own nor lease any real estate in any other state and did not travel outside of Michigan to conduct any business. All business contracts were made with various feedlot operators and bank representatives coming to Michigan to meet with Petitioner, and were substantively subject to the laws of the State of Michigan. In addition, Petitioner had no mailing address or business location in any other state.

All parts of Petitioner's business, both beef production and

advertising, relied upon the services of one accountant. No separate set of books was maintained for the livestock operations and its income (or loss) as well as financial condition was co-mingled and integrated with Petitioner's advertising operations for tax and financial reporting purposes to enable Petitioner to obtain the lines of credit from Bank Oklahoma and Michigan National Bank, and to establish the true financial condition of the entire business.

The beef production segment of his business was profitable. However, because of the cash accounting method, and the fact that cattle were sometimes purchased in one tax year and sold the next, an accounting loss had to be reported on Federal Income Tax Form 1040, Schedule F, and the same on Michigan tax returns.

Petitioner at all times regarded his beef production segment and his advertising segment conducted from his Michigan location as part of a unitary business.

The Michigan Department of Treasury audited Petitioner's returns and added back losses associated with Petitioner's beef production segment.

The Respondent asserts that Petitioner's beef production business is separate and distinct from its advertising business, the business income (losses) of which were attributed solely to the State of Texas and Petitioner must therefore add back the losses for Michigan income tax purposes.

The Michigan Tax Tribunal framed the issue as whether Petitioner established the required criteria in order to qualify as a unitary business and justify apportioning his multi-state business income. It ruled in Respondent's favor relying on the Michigan Court of Appeals decision in *Holloway Sand & Gravel Company, Inc.* v. *Department of Treasury*, 152 Mich. App. 823, 393 N.W.2d 921 (1986). The Michigan Tax Tribunal looked to the enumerated five factors held by *Holloway* to be the guideposts in determining whether a multi-state business is unitary or discrete.

They are (1) economic realities, (2) functional integration, (3) centralized management, (4) economics of scale and (5) substantial material interdependence.

In considering the *Holloway* factors, the Tax Tribunal found that while the Petitioner met the requirement of centralized management, it failed to meet the other four requirements which it found necessary to establish the criteria required for a unitary business. The totality of the circumstances was therefore found by the Tax Tribunal to support the Department of Treasury's tax determination.

The Michigan Court of Appeals affirmed the judgment of the Tax Tribunal relying again on the *Holloway* five factors. The Michigan Court of Appeals did not accept the Petitioner's assertion of the importance that the rule of centralized management played in the unitary business determination and found *Russell Stover Candies, Inc.* v. *Department of Revenue*, 665 P.2d 198 (Montana Sup.Ct. 1983), *appl.dism'd* 464 U.S. 988 (1983) *reh.den.* 465 U.S. 1014 (1983) to be distinguishable and non-binding on the Michigan court.

ARGUMENT IN SUPPORT OF THE FEDERAL QUESTIONS PRESENTED AND REASONS FOR GRANTING THE WRIT

The decision by the Michigan Court of Appeals should be reversed because it is flatly inconsistent with the settled decisions of this Court. The confusion caused by this decision disrupts the orderly administration of the assessment of both individual and corporate income taxes in Michigan and in any other state with a similar holding by its highest court. Either the decision below misinterprets the import of this Court's opinion in *Container Corp. of America* v. *Franchise Tax Board*, 463 U.S. 159 (1983), or, if it does not so interpret, the issues of far reaching importance left undecided in that case must be faced. In either event, this Court should grant review.

Beginning with the 1980 Term, this Court undertook to

resolve the controversy in the States concerning the scope of the unitary business definition. Beginning with *Mobil Oil Corp.* v. *Commissioner of Taxes of Vermont*, 445 U.S. 425 1980) and carrying on through with *Container Corp.*, *supra*, the two requirements for a unitary business are consistently interposed, a minimal connection or nexus between the interstate activities and the taxing state and a rational relationship between the income contributed to the state and the interstate values of the enterprise. See *Mobil Oil Corp.*, *supra* at 436, 437.

While Petitioner's case does not involve the taxation of dividends received by a subsidiary corporation and affiliates, but rather the taxation of a business venture engaged in by an individual sole proprietor, the critical inquiry is the same. Does the relationship between the ventures fall within the unitary business definition?

Petitioner wishes to emphasize that *Container Corp.* did not establish a five factor unitary business test which was devised by the Michigan Court of Appeals. Instead, it held that the underlying premise of the unitary business concept is that the "out-of-state activities of the purported 'unitary business' be related in some concrete way to the in-state activities". Id at 166. A concrete relationship is established by "some sharing or exchanging of value—beyond the mere flow of funds arising out of a passive investment—"*Id* at 166.

Paradoxically, having found that Petitioner conducted his business activities in the form of a strong one-man centralized management who was in charge of all aspects of his varying business activities, the Michigan Court of Appeals should have followed the tests set forth in *Container Corp.* and in *Exxon Corp.* v. *Wisconsin Department of Revenue*, 447 U.S. 207 (1980). As in *Exxon* the presence of a strong centralized management should have been held to be an overriding indication of a unitary business.

The five factor formula in *Holloway* devised by the Michigan

Court of Appeals in finding that Petitioner did not conduct a unitary business is nothing more than a return to the restrictive flow of goods criteria rejected in *Container Corp.* In describing the indicia of a unitary business as being an unquantifiable sharing or exchange of value, the Court in *Container Corp.* expanded the scope of the relevant criteria. The flow of value standard is a far broader concept than the *Holloway* so-called five-factor formula in establishing the entire unitary business inquiry.

Additionally, the facts of this case demonstrate substantial mutual interdependence arising from the activities of the Petitioner. See *Container Corp.*, 463 U.S. at 179. General management decisions were made exclusively by Petitioner from his Southfield, Michigan office. All funds generated by any activity were co-mingled and utilized for any needs of the various segments of Petitioner's business. Beef production activities were such that they could not operate or exist without the services provided by Petitioner.

When an out-of-state activity cannot operate without relying on the management provided by the local office for anything other than the most routine day-to-day decisions and where all centralized services including such simple things as balancing the checkbook, making bank deposits, paying bills or the influx of capital to meet the basic cash needs, it is inconceivable to find that the out-of-state activity is not dependent upon the operations of the business conducted in the local home state.

When an activity is so intertwined with the centralized management of the business as in the situation now before this Court, notwithstanding that it involves a different activity, it cannot be said that it constitutes an unrelated business activity.

The Michigan Tax Tribunal departed from this Court when it held that the business activities of Petitioner were not functionally integrated notwithstanding that Petitioner was found to have conducted all administrative services from his sole business office in Michigan and actively engages in beef

production for profit.

In *Exxon* a business is functionally integrated when interaction between the income-earning activities of the business is coordinated by a centralized management team. In *Exxon,* the functional departments were operated as independent businesses.

Despite the independence of the functional departments, the Court found that all the departments benefitted from "an umbrella of centralized management and controlled interaction", 447 U.S. at 224. Under this umbrella, this Court held that various departments formed a single unitary business.

Further, on facts resembling those presented here, state courts have held businesses to be unitary. See *Russell Stover Candies Inc.* v *Dep't. of Revenue,* supra (in-state cattle ranch divisions and out-of-state paper box divisions constituted a unitary business where there was a common bank account, centralized management and mutual dependence); *Pentzien, Inc.* v. *Dep't. of Revenue,* 418 N.W.2d 546 (Nebraska Sup.Ct. 1988) (horse farm operations and pipeline construction business constituted a unitary business where there was centralized management).

It is apparent that the Michigan Court of Appeals has failed to come to grips with the fact that the *Container Corp.* standard is less stringent and far broader than the three part formula enunciated by this Court in *Mobil Oil Corp., ASARCO Inc.* v. *Idaho State Tax Commission,* 458 U.S. 307 (1982) and *F.W. Woolworth Co.* v. *Taxation & Revenue Department,* 458 U.S. 354 (1982) that a unitary business is one which results from---functional integration, centralization of management and economies of scale. "*Mobil Oil Corp.*, 445 U.S. at 438. It was by applying this expansion of that 3 part test that the Michigan Tax Tribunal made the factual finding that the beef production activities and advertising businesses of Petitioner were not unitary.

The important contribution which the "flow of value" standard makes to the administration of the state taxation laws is that: if a business is found to be unitary, the State need not establish an individual nexus to each of the various diverse activities which it may be engaged so long as the activities are related to each other in some concrete way. It is in this context that a strong one-man centralized management, as is present in this case, is sufficient without more to constitute a unitary business under *Container Corp.*

Nothing in the decisions of this Court in *ASARCO* or *F.W. Woolworth* contradict in any way the finding of a unitary business in the present case. The facts of those cases clearly are distinguishable from the present case. Beginning with *F.W. Woolworth,* this Court found that there was no integration between *F. W. Woolworth* and its subsidiaries since the subsidiaries operated autonomously and independently. The subsidiaries had their own separate and complete accounting department and financial staff; and each subsidiary was responsible for obtaining its own financing from sources other than the parent. 458 U.S. at 305, 366. The subsidiaries developed their own sales programs, managerial staff, and instructed their staff in their own methods of operation. They developed their own policies with regard to retailing, they were responsible for determining the size and location of their stores, market conditions, and items to be sold. The parent did not review the tax returns or consult with them on decisions affecting taxes. Woolworth had no policy requiring that subsidiary managers carry out meetings. The most that could be said was that Woolworth had irregular and infrequent contact and then only for occasional oversight. Likewise in *ASARCO*, supra, this Court found that because the subsidiaries were not realistically subject to even minimal control by the parent, they were passive investments, in the basic sense of that term, and could not be included as a portion of the unitary business.

The facts of *F.W. Woolworth* and *ASARCO* are distinguishable from the present case and in no way

contravene this Court's opinions in those matters. The facts of the present case are more akin to the *Container* decision. In *Container* there was a substantial role played by the parent in loaning funds to the subsidiaries and guaranteeing loans provided by others. There was substantial technical assistance provided and supervisory role played by the officers in general guidance. 463 U.S. at 179.

The facts in the present case clearly are also distinguishable from the *ASARCO* and *F.W. Woolworth* cases, and are consistent with the *Container* decision. The activities of the Petitioner in beef production did not constitute an unrelated business investment, but were in fact an expansion of its financial resources into an area of which Petitioner had knowledge. Beef production was incorporated as a part of the totality of the Petitioner's method of operation. This type of assimilation was discussed in *Container.*

> "The difference lies in whether the management role that the parent does play is grounded in its own operational expertise and its overall operational strategy. In this case, the business "guidelines" established by appellant for its subsidiaries, the "consensus" process by which appellant's management was involved in the subsidiaries' business decisions, and the sometimes uncompensated technical assistance provided by appellant, all point to precisely the sort of operation role we found lacking in *F.W. Woolworth.*" 463 U.S. at 180, n.19.

Holloway erroneously established five criteria in determining a unitary business and apparently requires fulfillment of all of said criteria. This Court has never adopted a majority factor or an all-or-nothing approach to the unitary business determination. Instead it looks to the overall activities of the taxpayer to determine whether such activities contributed to the value of the overall business of the taxpayer. See *Container Corp.*, 463 U.S. at 178.

CONCLUSION

The failure by the Michigan Court of Appeals to understand the importance of the finding of "centralized management" in Petitioner's case led to its erroneous conclusion of the unitary business issue. Centralized management has been held by *Container Corp.* to be a factor of "great importance", 173 Cal. Rptr. 121, 127 (1981), aff'd 463 U.S. 159 (1983). See also *Exxon* v. *Department of Revenue,* supra. The fact is that a unitary business exists when the central management group is highly involved in all aspects of the day-to-day operations of each unrelated segment of the business, especially in the case of an individual taxpayer who does not delegate his business endeavors to other managers.

As an ad hoc method of approaching the problems of diverse business activities, the five factors *Holloway* criteria followed by the Michigan Court of Appeals is overly harsh, confiscatory, and violative of due process because instead of requiring a "minimal nexus" or "minimum contact" in order to qualify as a unitary business and to satisfy apportionment, a different more restrictive test is utilized. The test is not organized in any order of importance, weight, or number. With *Holloway,* it is "all or nothing," with *Container Corp.*, a "minimal" connection is all that is required.

Petitioner is not requesting this Court to act as a court of first instance merely to re-examine the findings of the Michigan Court of Appeals. That does not mean, however, that this Court cannot, however, examine whether the Michigan Court of Appeals applied the correct legal standards to the findings of fact. An examination of the entire record will show that the result of the decision below violates Petitioner's constitutional rights since its decision rested on a unitary business definition that fails to conform to the "functional realities" and "underlying activity" of the Petitioner's business enterprises. In such case, this Court has the power to arrive at an independent judgment on this issue. *Norton Co.* v. *Department of Revenue,* 340 U.S. 534, 537-538 (1951). Petitioner

respectfully requests that a Writ of Certiorari issues to this end.

A premise which must be established is that this case involves the imposition of taxes with respect to an individual taxpayer and that the imposition of taxes is a function of income. This case is not a case involving a complex corporate organization. In a case involving the diverse business activities of an individual entrepreneur, it is not sufficient merely to characterize the diverse business activities as separate and concrete as did the Michigan Tax Tribunal and conclude that they therefore were not unitary in nature because of that diversity.

As an ad hoc method of solving the problems of characterizing diverse business activities, the factors criteria of Holloway has proven less than satisfactory because the unitary factors have not been organized into an order of importance. Taxpayers and tax administrators attempting to characterize the activities of a diverse business are not certain which of the factors are essential to the existence of unity, which factors are important to the existence of unity, and which factors do not evidence unity. Uncertainty in the characterization of diverse business activities carries all the way through the filing process to the determination of taxable income and the income tax liability.

This case presents the Court with the opportunity to further define the applicability of the unitary business principle, to restrict the concept of discrete business enterprises and to state that the elements relied on here are sufficient to constitute a unitary business.

The decision rendered by the Michigan Court of Appeals is not sufficient, given the recent decisions of this Court, to so narrowly delimit the application of the unitary business principle so as to exclude its coverage to the Petitioner's business operations. The facts involved here, which demonstrate that the Petitioner's beef production is not a

separate business enterprise because of its centralized management, *et.al.*, reveal that the decision of the Court of Appeals of the State of Michigan falls outside the "realm of permissible judgment". *Norton Company* v. *Department of Revenue*, 340 U.S. 534, 538 (1951). As such, that judgment is not entitled to deference from this Court. The evidence in this case clearly indicates that Michigan seeks to unduly restrict the scope of the Court's unitary business principle. State courts should not be allowed to disregard the concept of "unitariness" to justify determinations of taxing authorities without performing the required analysis of the functional business realities of the taxpayer and the proper, non-discriminatory application of Federal and State constitutional law. In this light, the indicia of unitariness which the Michigan Court of Appeals found to be determinative with respect to the Petitioner's activities have no relevance to the production of income which should be the basis for the imposition of taxes. It is important to the ideal of a consistent state tax policy that the state courts adhere to the Court's decisions on unitariness as it relates to such functional realities as centralization of management and to flows of values, and not to the irrelevant, amorphous concept of separate business indicia.

For the reasons stated, this Petition for Writ of Certiorari should be granted.

Respectfully submitted,
Maurice S. Reisman
Attorney for Petitioner

APPENDIX A

STATE OF MICHIGAN
COURT OF APPEALS

MORTON H. JAFFE,
Petitioner - Appellee,

vs. No. 100975

MICHIGAN DEPARTMENT OF TREASURY,
Respondent - Appellee.

Before : R. S. Gribbs, P.J. Beasley, and G.A. Drain, *
JJ. per curiam.

Petitioner Morton H. Jaffe, doing business as Morton Jaffe Associates, appeals by right the May 18, 1987, judgment of the Michigan Tax Tribunal, which sustained respondent Department of Treasury's decision and order assessing additional individual income tax liability against Jaffe in the amount of $5,340.93 in interest, for a total of $38,556.93 for tax years 1981, 1982 and 1983. This disputed assessment arises from the Department's determination that Jaffe's cattle operation and advertising activities were not a unitary business, and that therefore Jaffe could not offset beef production losses against his advertising revenues for the years in question.

Petitioner argues on appeal that the hearing officer misapplied the five-factor unitary business test since the findings of fact were not supported by substantial evidence. Plaintiff also asserts that the Tribunal committed reversibleerror in failing to apply the standards set forth by the United States Supreme Court to determine a unitary business.

Appellate review of a Tax Tribunal decision is limited to

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*Recorder's Court judge, sitting on the Court of Appeals by assignment

determining whether the action is supported by law and whether the findings of fact are supported by competent, material and substantial evidence on the whole record. *Master Craft* v. *Treasury Dep't,* 141 Mich. App 56, 68; 366 NW2d 235 (1985). "Substantial evidence" must be more than a scintilla of evidence, although it may be substantially less than the preponderance of the evidence required for most civil cases. *Russo* v. *Dep't of Licensing & Regulation,* 119 Mich. App 624, 631; 326 NW2d 583 (1982). The burden of proof in an appeal from an assessment, decision, or order of the Tax Tribunal is on the appellant. *Holloway Sand & Gravel Co, Inc* v. *Dep't of Treasury,* 152 Mich App 823, 831, n 1; 393 NW2d 921 (1986).

In order to qualify as a unitary business and justify apportioning his multi-state business income, Jaffe carried the burden of establishing a nexus between his Michigan advertising activities and the cattle operation carried out in Texas. For where the attributes of an interstate unitary business are lacking, apportionment provisions do not apply. *Holloway,* pp 829-830, citing *Mobil Oil Corp* v. *Comm'r of Taxes of Vermont,* 445 US 425, 440; 110 S Ct 1223, 1232; 63 L Ed 2d 510 11980), and *F W Woolworth Co* v. *Taxation & Revenue Dep't of New Mexico,* 458 US 354, 372; 102 S Ct 3128, 3138-3139; 73 L Ed 2d 819 (1982).

The hearing officer in the instant case determined that the minimum contact or nexus required to support apportioned taxation was lacking, and identified the following five factors in reaching his conclusion: (l) economic realities; (2) functional integration; (3) centralized management; (4) economies of scale; (5) substantial mutual interdependence. The *Holloway* Court credited these five factors with being guideposts in determining whether a multi-state business is unitary or discrete.

Since the hearing officer was legally correct in following *Holloway,* which in turn relied on the United States Supreme Court's guideposts in distinguishing unitary businesses, the proper law was applied to Jaffe's business activities. The real

issue is whether his findings of fact with regard to the guideposts were supported by competent, material and substantial evidence on the whole record. *Master Craft, supra.*

Jaffe testified that the only two ways in which the two business activities were related were: (1) the use of advertisement-generated credit to obtain financing for the cattle operation, and (2) that Jaffe alone managed both activities from his Michigan office.

Therefore, the hearing officer properly found that there was no functional integration of the activities. Also, he properly found no economies of scale, e.g., no resulting increase in profits or improved allocation of resources when considering the two activities as a unit. The only factor which Jaffe satisfied was that of centralized management. In this regard, Jaffe testified that the Texas feedlot operators were independent contractors with limited discretion to whom Jaffe directed instructions by telephone. Jaffe made virtually every important decision regarding the cattle operation and kept one set of books for both businesses. The hearing officer properly found that Jaffe met the test for the centralized management factor.

Jaffe argues that the extreme importance of the two business activities' centralized management should have resulted in a finding that the businesses were functionally integrated, as well, and unitary in nature. In support of this position, Jaffe quotes *Russell Stover Candies, Inc* v *Dep't of Revenue*, 665 P2d 190 (Mo 1983). This Court finds *Russell Stover Candies* to be not only factually distinguishable but non-binding on this Court.

Further, this Court's review of the Tribunal's decision is limited. In short, there was substantial evidence on the record that Jaffe's advertising and cattle operation activities were not functionally integrated or interdependent, and did not share economies of scale. This was evidenced by their only common denominator being Jaffe's control and operation of both businesses.

Aside from the centralized management aspect, the only connection between the two businesses was Jaffe's use of some advertising funds to secure credit for the cattle operation at the Oklahoma bank. The funds used as security were not broken down into "personal" or "advertising" funds at the hearing. Since Jaffe operated a sole proprietorship, presumably all profits derived from any of his business sources were personal, ultimately. Although both businesses were inextricably tied to Jaffe, they were not themselves interdependent. And to a substantial degree, the operation of the cattle operation was carried out in Texas rather than Michigan. This Court specifically finds that the Tribunal hearing officer did fairly determine that the businesses were not unitary based on the evidence produced by Jaffe.

This Court concludes that the hearing officer properly determined that Jaffe's advertising activities and cattle operation were not a unitary business. The hearing officer applied the proper standards, and there was substantial evidence on the record to support his decision.

Petitioner next contends that if his cattle operation constituted a separate business, then the losses from that operation should be treated as nonbusiness losses allocable to Michigan.

Jaffe did not make this particular claim before the Tribunal. His failure to raise the issue below precludes its consideration by this Court. *Dow Chemical Co* v *Curtis*, 158 Mich App 347, 352; 404 NW2d 737 (1987), lv gtd 428 Mich 911 (1987).

Moreover, Jaffe's argument that his cattle operation losses constituted nonbusiness income and should therefore be allocated to Michigan is without merit. Jaffe's cattle operation income or loss was business income as defined by the act. Therefore, Jaffe may not allocate such income to Michigan as nonbusiness income.

The Tribunal's judgment is affirmed.

/s/ Roman S. Gribbs
/s/ William R. Beasley
/s/ Gershwin Allen Drain

APPENDIX B

STATE OF MICHIGAN
MICHIGAN TAX TRIBUNAL

Morton H. Jaffe,
Petitioner

v.

Michigan Dept.
of Treasury,
Respondent

OPINION AND JUDGMENT

Tribunal Judge Presiding
Roger M. Groves

Petitioner, Morton H. Jaffe (taxpayer or Jaffe), appeals for redetermination of an assessment for Michigan individual income tax issued by Respondent, the Michigan Department of Treasury. The notice of final assessment was issued on April 17, 1985, and is in the amount of $33,226.00 tax and $5,340.93 interest, for a total alleged liability of $38,566.93. The tax years in controversy are 1981, 1982, and 1983. A hearing commenced on June 17, 1986, in the Tribunal's Lansing office.

Petitioner, represented by counsel, testified as the sole witness on his own behalf. Exhibits P-1 through P-4 were admitted, evidencing a debt slip from Bankoklahoma, two promissory notes, and a letter from Petitioner to Bankoklahoma.

Respondent, represented by counsel, elicited testimony from its income tax division supervisor. Exhibits R-1 through R-5 were admitted, evidencing the Petitioner's tax return filings and assessment history.

FINDINGS OF FACT

The following facts are undisputed:

1. Petitioner is resident individual of the State of Michigan.

2. Petitioner's only business address and office is located at 3000 Town Center, Southfield, Michigan.

3. Petitioner, as a sole proprietor, is engaged in an advertising business located in Michigan and is engaged in the ownership of cattle located in "feed lots" in the State of Texas.

4. During 1981, 1982, and 1983 Petitioner was engaged in the feeding of livestock and production of beef and incurred losses from said activity.

5. Petitioner duly filed and executed his Federal income tax returns for the tax years in question and, utilizing Schedule F, reported losses associated with the cattle operation (i.e., net losses) totaling: $164,423.88 for 1981 (Exhibit R-3a); $205,827.94 for 1982 (Exhibit R3b); and $221,892.45 for 1983 (Exhibit R-3c).

6. Petitioner was also engaged in advertising for the tax years in question and reported profits from this activity. Utilizing Schedule C, Petitioner declared the following profits on his Federal returns: 1982 — $152,428 (Exhibit R-3b); 1983 — $173,851.22 (Exhibit R3c) and the following gross proceeds: 1982 — $249,291.60; 1983 — $259,271.80.

7. Petitioner subtracted his Schedule F losses from gross income and, for Federal tax purposes, reported adjusted gross income of $18,939.54 for 1981 (Exhibit R-3a); $1,724.84 for 1982 (Exhibit R-3b); and $6,057.25 for 1983 (Exhibit R-3c).

8. Petitioner duly filed his Michigan income tax returns. Identical sums were reported on Petitioner's MI-1040's for 1981, 1982, and 1983.

9. Petitioner did not add back losses from the Texas cattle operation when calculating his Michigan taxable income.

10. Respondent adjusted Petitioner's returns by adding back the cattle operation losses in determining Petitioner's Michigan taxable income.

11. Respondent made further adjustments due to an IRS audit; these are not disputed by petitioner.

12. Respondent's assessment/Petitioner's deficiency for each of the tax years determined through audit and the notice of final assessment issued.

Petitioner contends his Michigan advertising business and his Texas beef production business comprise a unitary business therefore he could offset losses attributable to the beef production activities against other income. Respondent asserts that Petitioner's Texas feedlot operation is a separate and distinct business from its advertising business, the business income (losses) of which were attributable solely to the State of Texas and Petitioner must therefore add back the losses for Michigan income tax purposes. Because the unitary business theory is the question to be addressed, additional factual findings must be considered.

In 1979, intrigued by the possibility of personal profits, Petitioner became involved with the acquisition, ownership, and management of cattle. Petitioner Jaffe testified at hearing that he is engaged in a Michigan advertising business and a Texas feedlot operation and was so engaged during the tax years in controversy. On direct examination, Petitioner testified that he engages in business as a sole proprietor, and stated that in light of the size, cost, sales, capital, and time, the cattle feedlot operation is by far of greater magnitude of the two undertakings.

Petitioner maintains but one business office in Southfield, and asserts that all executive, financial and administrative matters of the advertising business *and* the cattle feedlot operation are controlled by him at this office. Petitioner testified that he did not nor does not own or lease any real estate in any other state and that he has no other mailing address in another state.

Petitioner stated that he hired one employee for his advertising business, a publications editor, but maintains no

employees in the beef production operation. Petitioner handles all the purchasing, feeding, sale of cattle and financing of the operation at his Southfield office. Petitioner communicates all management decisions concerning the Texas activity by telephone. He testified that, although some feedlot operators and financial representatives made visits to Michigan to meet with him, he did not travel outside Michigan to conduct any business.

Petitioner stated that no one advises him as to the management of the feedlot operation. Petitioner bases all of his decisions on his own knowledge and analysis. He stated that the risky nature of the business requires his personal involvement. After considering such factors as weight, type and price of the cattle and the proximity to the feedlots, Petitioner purchased the cattle by telephoning the seller's agent. He purchased in his name only.

On cross-examination, Petitioner testified that all cattle were sold unless death occurred. The sale of cattle, as testified by the Petitioner, begins with packers, as buyers, placing a bid with the feedlot operators, who relay the message to the Petitioner by telephone. Petitioner then communicates back with the feedlot operators as to whether the bid is accepted. Petitioner also purchased feed from grain elevators and engaged in "hedging" grain, a method of securing prices for future feed sales (see Exhibit P-1).

Petitioner testified that each operator of the feedlot is engaged by him as an independent contractor. There is no written contract and Petitioner can release an operator without notice. Each operator determines the mix of ration (i.e., the amount of grain, hay, vitamins, etc.) fed to the cattle and engages the services of a veterinarian, but has no authority beyond this to act in any manner without Petitioner's approval. On cross-examination, Petitioner admitted that these services and supplies were all provided in Texas and had no similar services or supplies for the advertising business.

All expenditures of funds in connection with the beef production activities were submitted to Petitioner for approval and payment. Petitioner received all bills of which he paid on an ongoing basis.

Petitioner testified that he required substantial financing, in addition to his business cash flow, in order to engage in the cattle feedlot operation. Annually, Petitioner acquired a line of credit from Bankoklahoma based on his business and personal assets. He also secured a loan from Michigan National Bank, Oakland branch, using certificates of deposit as collateral. (See Exhibits P-2, P-3, P-4.) Petitioner stated on cross-examination that no financing was needed for the advertising business but that the advertising business generated funds which allowed Petitioner to secure credit for the cattle operation.

Petitioner also noted that all beef production revenues were co-mingled with other business revenues. Petitioner utilizes the services of one accountant since no separate books were kept for the beef production business. Petitioner maintains that for financial and tax reporting purposes the beef production operation and the advertising business were integrated.

Conclusions of Law

The issue raised in the instant case is whether or not Petitioner's Michigan advertising business is a unitary business in determining Michigan individual income tax liability. Specifically, the issue is has Petitioner established the required nexus or minimum contacts in order to qualify as a unitary business and justify apportioning his multistate business income.

Section 103 of the Michigan Income Tax Act, MCLA 206.1 *et seq;* MSA 7.556(101) *et seq,* provides that any taxpayer with income from business activity taxable within and without this state shall allocate and apportion net income as provided in the Act. MCLA 206.103; MSA 7.557(1103).

Michigan, in its adoption of the Uniform Division of Income for Tax Purposes Act (UDITPA), provides for formulary apportionment through which a unitary business may apportion its net business income using the three equally weighted factors of payroll, property and sales. MCLA 206.115; MSA 7.557(1115). Conversely, if the attributes of an interstate unitary business activity are lacking, the apportionment provisions do not apply. *FW Woolworth Co.* v. *Taxation and Revenue Department of New Mexico,* 458 US 354, 372; 102 SCt 3128; 73 LE2d 819 (1982). See, also, Rudolph, *State Taxation of Interstate Business — The Unitary Business Concept and Affiliated Corporate Groups,* 25 Tax L Rev 171, 192 (1970).

In *Holloway Sand & Gravel Company, Inc.* v. *Department of Treasury,* 152 Mich App 823 (1986), the Court considered whether the taxpayer's Michigan business of sand and gravel production was unitary for corporate income tax purposes, with its operation of a speedway in Texas. In holding that the businesses were not unitary, the Court enumerated five factors to consider in determining the minimal contacts or nexus necessary to find a unitary business. There are: 1) economic realities; 2) functional integration; 3) centralized management; 4) economics of scale; and 5) substantial material interdependence. For reasons detailed below, this Tribunal finds the above case controlling of the instant controversy, to the same result that Petitioner does not prevail.

In considering the first factor, economic realities of the two businesses, the Court, in *Holloway* referred to *Mobil Oil Corp.* v *Comm'r of Taxes of Vermont,* 445 US 425; 100 SCt 1223; 63 LE2d 510 (1980) and stated that the form of business is irrelevant to the unity or diversity of the business enterprise, but rather it is the underlying activity that must be scrutinized. In Holloway, the Court held that the activity of Petitioner's incorporated Michigan sand and gravel operations was wholly distinct and separate from the activity of its Texas speedway. Although petitioner Jaffe engages in business as a sole

proprietor, and is not incorporated like Petitioner Holloway, the same principle is applicable since the form of business enterprise is immaterial. Petitioner Jaffe testified that such activities of daily management, services and goods necessary for the production of beef are in no way connected to the advertising business. The underlying activity of an advertising business and of a cattle operation is wholly distinct and separate and Petitioner Jaffe fails to meet this requirement.

Functional integration, the second factor to be considered, has been referred to as a "key yardstick... in drawing the line between a 'unitary' and a 'discrete business'". Hellerstien, *Corporate Income and Franchise Taxes,* Warren, Gorham & Lamont, p 424 (1983). Its existence is noted when there is a blending of business functions to create one harmonious corporate organism. The Court, in *Holloway,* found that petitioner's two businesses were not functionally integrated, and cited the following facts to support its conclusion: 1) the two companies acted autonomously except for centralized administrative services in Michigan; 2) the speedway did not enhance the use of the sand and gravel company's existing resources; 3) the track was purchased as an investment to protects taxpayer's financial interest; and 4) there was no substantial flow of value between the speedway and the sand and gravel enterprise.

Although Petitioner Jaffe conducts all administrative services from his sole business office in Michigan and actively engages in beef production for profit, his two businesses are not functionally integrated. Both the advertising business and cattle production operation act independently as to daily activities. The goods and services required for beef production have no relation to the goods and services required for advertising business. There is no flow of goods from one business to the other, nor is there flow of value. Petitioner Jaffe testified that the Texas cattle operation lends no support, financial or otherwise, to the Michigan advertising business. Petitioner testified that it is his personal and Michigan

advertising business assets that allow him to pursue his Texas cattle operation. The fact that Petitioner may oversee both enterprises does not presumptively preclude the finding of separate and distinct businesses. *Holloway, supra,* p. 832. Consequently, Petitioner has failed to show functional integration of his two businesses.

As to the third factor, Petitioner Jaffe has shown evidence of centralized management. Petitioner testified that: 1) all feedlot operators are independent contractors who were hired by Petitioner through his Southfield office; 2) Petitioner made all decisions regarding the purchasing, selling and financing of the cattle operation; 3) Petitioner made decisions regarding the purchase of grain except that the feedlot operators determined the mix of ration for the cattle and enlisted the services of a veterinarian; 4) no separate books were kept for each business; 5) Petitioner utilizes the services of one accountant since revenues for both businesses were co-mingled; and 6) Petitioner communicated directly to the feedlot operators. Petitioner has met this requirement.

The fourth factor is economics of scale.In *Holloway,* the Court, in concluding that economics of scale were not achieved, stated that consolidation of the operations failed to elicit evidence of any benefits. The Court stated that although centralized purchasing occurred in Michigan, evidence was lacking as to increased profits through bulk purchases or an improved allocation of resources. Petitioner also failed to show the ability to secure financing at a more advantageous rate.

Here, too, Petitioner Jaffe failed to show evidence that a benefit is obtained through the consolidation of the businesses.

Petitioner Jaffe purchased his goods and services for the cattle operation in Texas and they were used exclusively for the cattle operation. Although Petitioner conducted all business through his Southfield office, he failed to show how this increased his profits by means of bulk purchases or improved allocation of resources. Also, Petitioner testified that

he was able to obtain financing for the cattle operation due to his personal and advertising business assets but failed to show an increased ability to secure financing at a *more* advantageous rate.

The last factor, substantial material interdependence, is also lacking in Petitioner Jaffe's businesses even through, as sole administrator, he engages in all administrative, executive and financial aspects from his Michigan office. The requisite substantial mutual interdependence exists when there is a "showing that a quantifiable flow of business value existed or that no enterprise's stable operations was important to the other's 'full utilization' of capacity". *Holloway, supra,* p 834, citing *FW Woolworth Co.* v. *Revenue Dept of New Mexico,* 458 US 354, 102 SCt 3128; 73 LEd2d 819 (1982). Petitioner testified that the Michigan advertising business receives no goods, services or financial value from the Texas feedlot activities. The Michigan advertising business stability is no way dependent upon the cattle operation's "full utilization of capacity". If the cattle operation began to suffer financial woes, the advertising business would clearly be unaffected. Consequently, Petitioner fails to meet this factor.

Also noteworthy is *Donovan Construction Co.* v. *Dept of Treasury*, 126 Mich App 11, 22; 337 NW2d 297 (1983). In that case, the Court held the business not to be unitary, in significant part because "basic interdependent operations [were] not carried on to a substantial degree in more than one state... [thus] there [was] no occasion for apportionment". In the instant case, to a very substantial degree, the operation of the cattle lot was confined to the State of Texas. The actual buyers and agents of Petitioner for negotiation of sales conducted virtually all activity in Texas. Petitioner's input from Michigan was essentially telephonic.

In light of the forementioned factors, Petitioner Jaffe has failed to meet four of the five requirements necessary to establish the minimum contacts or nexus required to establish a unitary business. Although Petitioner established the factor

of centralized management, the totality of the circumstances precludes Petitioner from prevailing on its claim.

Judgment

IT IS THEREFORE ORDERED AND ADJUDGED that Assessment No. C376900 be and is hereby AFFIRMED.

MICHIGAN TAX TRIBUNAL

By: Roger M. Groves

Entered: May 18, 1987

APPENDIX C

Order

Entered:

June 7, 1989

84178
MORTON H. JAFFE,
Petitioner-Appellant,

v.

MICHIGAN DEPARTMENT OF TREASURY,
Respondent-Appellee.

SC: 84178
COA: 100975
LC: MTT 91995

On order of the Court, the application for leave to appeal is considered, and it is DENIED, because we are not persuaded that the question presented should be reviewed by this Court.

10601

I, CORBIN R. DAVIS, Clerk of the Michigan Supreme Court, certify that the foregoing is a true and complete copy of the order entered at the direction of Court.

June 7, 1989

Corbin R. Davis
Clerk

APPENDIX D

Order

Entered:

August 29, 1989

84178 (35)

MORTON H. JAFFE,
Petitioner-Appellant,

v.

MICHIGAN DEPARTMENT OF TREASURY,
Respondent-Appellee.

SC: 84178
COA: 100975
LC: MTT

On order of the Court, the motion for reconsideration of this Court's order of June 7, 1989 is considered, and it is DENIED because it does not appear that the order was entered erroneously.

50822

I, CORBIN R. DAVIS, Clerk of the Michigan Supreme Court, certify that the foregoing is a true and complete copy of the order entered at the direction of Court.

August 29, 1989

Corbin R. Davis
Clerk

APPENDIX E—RELEVANT STATUTES

The Michigan Income Tax Act, 1967 PA 281, MCL 206.1, *et seq:* MSA 7.557 (1), *et seq* provides in pertinent part.

"Sec. 301(1) 'Taxable income' in the case of a person...means adjusted gross income as defined in the Internal Revenue Code subject to the following adjustments:

* * *

"(k) adjustments resulting from the allocation and apportionment provisions of Chapter 3..."

"Sec. 102. In the case of taxable income of a taxpayer whose income-producing activities are confined solely to this state, the entire taxable income of such taxpayer shall be allocated to this state; except as otherwise expressly provided in this act.

"Sec. 103. Any taxpayer having income from business activity which is taxable both within and without this state, other than the rendering of purely personal services by an individual, shall allocate and apportion his net income as provided in this act.

"Sec. 105. For purposes of allocation and apportionment of income from business activity under this act, a taxpayer is taxable in another state if (a) in that state he is subject to a net income tax, a franchise tax measured by net income, a franchise tax for the privilege of doing business or a corporate stock tax, or (b) that state has jurisdiction to subject the taxpayer to a net income tax regardless of whether, in fact, the state does or does not.

"Sec. 110. In the case of a resident individual,... all taxable income from any source whatsoever, except that attributable to another state under provisions of sections 111 to 115...is allocated to this state.

"Sec. 115. All business income, other than income from transportation services shall be apportioned to this state by multiplying the income by a fraction, the numerator of which is the property factor plus the payroll factor plus the sales factor, and the denominator of which is 3."